NO. 20,281

United States Court of Appeals for the Ninth Circuit

MURPHY LOGGING CO., successor by merger to Murphy Timber Co.; HARRY C. MURPHY and DOROTHY SHEA MURPHY; EDWARD J. MURPHY and VIRGINIA C. MURPHY; PETER C. MURPHY and DOROTHY Z. MURPHY,

Appellants

v.

UNITED STATES OF AMERICA,

Appellee

On Appeal From the Judgment of the United States District Court for the District of Oregon

BRIEF FOR THE APPELLEE

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OPINION BELOW

The opinion of the District Court (I-R. 13-19)[1] is officially reported at 239 F. Supp. 794.

JURISDICTION

This appeal involves federal income taxes for the calendar years 1959 and 1960 with respect to Harry,

[1] "I-R." and "II-R." references are to Volume I and Volume II, respectively, of the record on appeal.

Edward and Peter Murphy and their wives,[2] and for the fiscal years ended February 29, 1960, and February 28, 1961, with respect to the corporate taxpayer. (I-R. 7-8). The taxes in dispute were paid on May 17, 1963. (I-R 6.) Claims for refund were filed June 13, 1963 (I-R. 7-8), and were rejected on October 8, 1963 (I-R. 8). Within the time provided in Section 6532 of the Internal Revenue Code of 1954, on November 14, 1963, the taxpayers brought this action in the District Court for recovery of the taxes paid. (I-R. 27.) Jurisdiction was conferred on the District Court by 28. S.C., Section 1346. The judgment of the District Court was entered on May 17, 1965. (I-R. 20.) Within sixty days thereafter, on June 22, 1965, a notice of appeal was filed. (I-R. 21). Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTIONS PRESENTED

1. Whether the District Court erred in holding that the transfer of machinery and equipment to the newly-formed taxpayer corporation was part of the tax-free formation of the corporation under Section 351 of the Internal Revenue Code of 1954 rather than an independent sale.

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[2]The wives are parties to this action only because joint returns were filed for the years involved. (I-R. 15.)

2. Whether the District Court erred in holding that a bank loan of $240,000 purportedly made to the corporate taxpayer was in substance and reality a loan to Harry, Edward and Peter Murphy as individuals.

STATUTES AND REGULATIONS INVOLVED

The pertinent portions of the statutes and Regulations are set out in Appendix A, *infra*.

STATEMENT

The facts as found by the District Court (I-R. 13-15) are as follows:

For some years prior to February 2, 1959, three brothers — Harry, Edward and Peter Murphy — operated the Murphy Logging Company as partners. Each received a salary of $25,000 per year, and profits, if any, were distributable in the same proportions as their interests, namely, Harry 53 1/3 per cent, Edward 33 1/3 per cent, and Peter 13 1/3 per cent. (I-R. 13.)

On February 2, 1959, the Murphy brothers organized the Murphy Timber Company, an Oregon corporation. This corporation was capitalized at $1,500, and each of the Murphy brothers agreed to purchase $500 in stock. (I-R. 13).

On March 1, 1959, the Murphy partnership agreed to sell, and at the same time delivered, some of its logging equipment which was carried on the books at $28,414.10 to the new corporation at a price to be determined at a later date by an independent appraiser. On the same day, the Murphy corporation entered into two standard form written contracts to log and to construct roads for the Crown-Zellerbach Corporation. Shortly thereafter, it undertook to perform such contracts. (I-R. 14).

On April 6, 1959, each of the Murphy brothers paid the corporation $500 for his stock. One week later, the corporation borrowed $25,000 from the First National Bank of Oregon to carry on its operations, and between May 4 and July 30 the corporation borrowed additional sums totalling $50,000 for the same purpose from the bank. (I-R. 14.)

In September, an independent appraiser fixed the value of the equipment transferred to the corporation at $238,150. On December 31, 1959, the corporation borrowed a total of $240,000 from the bank, and on the same day the corporation paid $238,150 to the partnership. All of the bank loans were guaranteed by the brothers individually. (I-R. 14.)

In the partnership tax return for the calendar year 1959, the partners reported a long-term capital gain of $209,735 on the sale of this equipment, and each of the partners filed a return and paid a tax on his distributive share of the gain. (I-R. 14.) The Commissioner of Internal Revenue disallowed the claimed depreciation and interest deductions taken by the corporation and asserted deficiencies both aganist the corporation and the Murphy brothers individually. (I-R. 14-15.) The District Court held that the real substance of the pertinent transactions was a capital contribution of equipment to the corporation and a loan by the bank to the brothers as individuals as contended by the Government. (I-R. 19.) Because the individual partners had reported their gain on the transfer of the equipment and had paid tax on this gain (I-R. 6), the District Court ordered refunds to them (I-R. 20). Both the corporation and the individuals have appealed.

SUMMARY OF ARGUMENT

The District Court held that depreciable property transferred in March, 1959, to the corporate taxpayer as one of the steps in its formation was a contribution to its capital and that a bank loan formally made to the corporation in December, 1959, was in reality a

loan to its shareholders as individuals. This means that the corporation's deduction for depreciation is reduced and that corporate payments to the bank on the loan are dividends to the shareholders (who are themselves entitled to the interest deduction).

Under Section 351 of the 1954 Code no gain is to be recognized by a controlling transferor on the transfer of property for his equity interest in a corporation, and the basis of the property for depreciation remains the same as it was to the transferor. Taxpayers argue that the transfer here should be treated as a sale independent of Section 351, but the transfer was clearly a part of the transaction of incorporation, to be considered under that section. Indeed, the new corporation was formed for the very purpose of taking over the property in question. Unless the equipment is treated as part of the equity capital, the new corporationtion was undercapitalized from the outset.

Of essential importance to the District Court's holding is its consideration of the bank loan of $240,000 which was formally made to the corporate taxpayer. This loan was negotiated on the guarantee of the three Murphy brothers as individuals, and the funds immediately went to their partnership in purported payment for the depreciable property. The District Court, on

the basis of all the evidence in this case, concluded that the loan was in fact to the Murphys on their credit and that the corporation was merely a conduit for the funds from the bank to them. This is a factual determination and is clearly warranted on this record.

ARGUMENT

I

THE TRANSFER OF MACHINERY AND EQUIPMENT TO THE NEWLY-FORMED CORPORATE TAXPAYER BY ITS PREDECESSOR PARTNERSHIP WAS PART OF THE TAX-FREE FORMATION OF THE CORPORATION UNDER SECTION 351 OF THE INTERNAL REVENUE CODE OF 1954 RATHER THAN AN INDEPENDENT SALE.

This case involves an adjustment reducing the corporate taxpayer's depreciation deduction and a separate adjustment disallowing an interest deduction claimed by the corporate taxpayer.[3] With respect to the depreciation issue, the taxpayers attempt to demonstrate that the property involved was the subject of a separate transaction of sale to the corporation rather than an essential ingred-

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[3]The District Court held that the indebtedness involved here was in fact the obligation of the corporation's shareholders (Harry, Edward and Peter Murphy, the individual taxpayers who are parties to this suit) and that payments made by the corporation as interest and principal on the indebtedness are constructive dividends to them. Of course, the Murphys are entitled to the interest deduction.

ient in its tax-free formation (with a carryover of the low basis of the transferor). As for the interest adjustment, the taxpayers argue that the District Court erred in considering a bank loan as in reality a loan to the Murphys as individuals. Resolution of the depreciation issue is not decisive of the interest question. See *Campbell* v. *Carter Foundation Production Co.,* 322 F. 2d 827 (C.A. 5th). Cf *Gooding Amusement Co.* v. *Commissioner,* 236 F. 2d 159 (C.A. 6th), certiorari denied, 352 U.S. 1031. Neverless, the bank arrangement is an important factor in the consideration of the Section 351 (Appendix A, *infra*) incorporation transaction and the question whether the property transferred to the corporation retains the basis of the transferor. In this first part of our brief we will discuss the incorporation transaction and the legal principles involved in light of all the facts. In the last part of the brief we will focus on the loan arrangement.[4]

Under the general rule of Section 1002 of the Internal Revenue Code of 1954 (Appendix A, *infra*), the entire amount of gain or loss from the sale or exchange of property is to be recognized. An exception to this general rule is contained in Section 351 of the 1954 Code (Appendix A, *infra*) to assist business re-

[4]Significant portions of the evidence are based on the oral testimony of the witnesses.

adjustments. See S. Rep. No. 275, 67th Cong., 1st Sess., pp. 11-12 (1939-1 Cum. Bull. (Part 2) 181, 188-189). The basic premise of Section 351 is that transfers of appreciated or depreciated property to a newly-formed corporation that is controlled by the transferors work a change of form only, which is not the proper occasion for reckoning gain or loss on the transferred property. See *Helvering* v. *Cement Investors,* 316 U.S. 527; *Portland Oil Co.* v. *Commissioner,* 109 F. 2d 479, 488 (C.A. 1st); *Mather & Co.* v. *Commissioner,* 171 F. 2d 864 (C.A. 3d), certiorari denied, 377 U.S. 907.

Section 351 provides that no gain or loss is to be recognized if property is transferred to a corporation by one or more persons in exchange for that corporation's stock or securities, and the transferors own at least 80 per cent of the stock after the transfer. As a corollary to the postponement of the tax on incorporation, under Section 362(a) of the 1954 code (Appendix A, *infra*), the transferee corporation's basis in the property for depreciation is the same as it would be in the hands of the transferor, increased or decreased in the amount of gain or loss recognized to the transferor upon the transfer.

In the instant case the corporate taxpayer was organized on February 2, 1959, for the express purpose of

taking over certain operating equipment owned by the Murphy Brothers' partnership.[5] (I-R. 13; II-R. 9.) The equipment was transferred to the corporation in March and was used to carry out a logging contract and a road construction contract which were entered into with Crown-Zellerbach at about the same time as the transfer. (I-R. 2-3). Thereafter, each of the Murphys paid the corporation $500 for his one third stock interest for a total of $1,500 paid-in capital, and up to July 30 the corporation borrowed $75,000 from the First National Bank of Oregon in order to carry on its operations. (I-R. 14.) In September, an independent appraiser valued the equipment transferred to the corporation at $238,150, and on December 31, 1959, the corporation borrowed $240,000 from the First National Bank of Oregon and transferred $238,150 of this to the Murphy brothers' partnership in settlement of its agreement to buy the logging equipment for the appraised value. (I-R. 314.)

It is the Government's position that the transfer of the logging equipment, which taxpayers wish to treat as an independent sale, is in fact an essential part of the Section 351 exchange transaction in which the corporate taxpayer was formed. The Murphys erred in re-

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[5]The equipment was carried on the partnership's books at $28,414.10. (I-R. 14.)

porting gain on this transfer because the property was exchanged for an equity interest in the new corporation, and the partnership's basis in the assets is carried over as the basis to the corporation pursuant to Section 362(a).

In determining whether the transfer of the operating assets was a sale independent of the tax-free formation of the corporation or is to be treated as part of the equity investment, an important consideration is the excessive disproportion between the corporation's nominal stock investment and its debt structure — the "thin capitalization." This factor has been important in the traditional situation involving debts owed by a corporation to its shareholders since the case of *John Kelley Co. v. Commissioner*, 326 U.S. 521, wherein the Supreme Court made the following observation (p. 530):

> As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.

Following the *Kelley* case the Tax Court and other courts placed great reliance on the ratio between debt and equity in deciding whether so-called "debt" in fact represented an equity investment, although no clear pattern was present. See Caplin, The Caloric Count of a Thin Incorporation, Seventeenth Annual N.Y.U. In-

stitute on Federal Taxation, pp. 771, 779-784 (1959). However, in *Gooding Amusement Co. v. Commissioner,* 23 T.C. 408, affirmed, 236 F. 2d 159 (C.A. 6th), certiorari denied, 352 U.S. 1031, the Tax Court ceased to rely primarily on the ratio test but used the subjective test of the "intent" to create a true debt relationship between shareholders and corporation. This Court has accorded great weight to the "intention" of the parties in the determination of whether purported debt is to be treated as an equity investment. *Taft v. Commissioner,* 314 F. 2d 620, 623, footnote 1; *Miller's Estate v. Commissioner,* 239 F. 2d 729, 734; *Wilshire & West. Sandwiches v. Commissioner,* 175 F. 2d 718, 720; *Maloney v. Spencer,* 172 F. 2d 638, 641; *Commissioner v. Proctor Shop,* 82 F. 2d 792, 794 (all cited by taxpayers, Br. 10, 21-22, 24, 28). Nevertheless, in *O. H. Kruse Grain & Milling v. Commissioner,* 279 F. 2d 123, 125-126, and *Wilbur Security Co. v. Commissioner,* 279 F. 2d 657, 662, this Court held that there are a variety of factors to be considered in determining whether amounts advanced to a corporation constitute debt or equity. Intent of the parties is one of these factors, and so is thin capitalization. See also, *Root v. Commissioner,* 220 F. 2d 240, 241 (C.A. 9th).

It is the Government's position that it would be unrealistic to apply the various factors set out in *Kruse*

and *Wilbur Security* without regard to the substance of the method by which the corporate taxpayer was supplied with risk capital. We will discuss in detail the District Court's holding (I-R. 19) that the $240,000 in borrowed funds were in fact loaned by the bank to the Murphy Brothers as individuals and that the transfer of the equipment represented a capital contribution to the corporate taxpayer. But even if the borrowed funds had in fact been utilized by the corporation to purchase assets from outsiders rather than going directly to the Murphys,[6] reason demands that this obvious device not be permitted to hide the ultimate reality of the transaction. As stated in Moore and Sorlien, Adventures in Subchapter S and Section 1244, 14 Tax L. Rev. 453, 493, footnote 108 (1959):

> It is possible that the reason for the paucity of authority on this point is the difficulty of focusing the attack. Nearly always a thin capitalization is placed under fire by denying the corporate deduction for interest paid the shareholder-noteholder. Sometimes the attack is on payment of the capital, which could be treated as a dividend or equity redemption substantially equivalent to a dividend. If a bank is the creditor, an additional step must be taken by the Commissioner, as the corporation will point out that the interest has been paid to a bank and ask how in the world the Commissioner

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[6]Such a case would be stronger for the taxpayers than the instant case where the very reason for forming the corporation was to operate the transferred equipment in corporate form. (II-R. 9.)

> can deny *that* deduction. The answer would have to be that the shareholder, by endorsing the note, has placed himself in a dual position — creditor of the corporation and debtor to the bank. In effect, then, the interest is paid to the shareholder, who in turn pays it to the bank. If the capitalization were thin, the analysis would be that the "interest" paid by the corporation was a dividend to the shareholder, who receives an equivalent deduction for interest paid the bank. Thus, the bank pays tax on the interest, the shareholder is even, and the corporation loses its interest deduction. Lest this reasoning be thought too strained, the Supreme Court dictum in the *Putnam* case (352 U.S. 82 (1956)), appears to support the conclusion and places in some jeopardy what had been thought by many to be a fairly simple escape-hatch to the thin capitalization doctrine.

Bittker, Federal Income Taxation of Corporations and Shareholders (Student ed., 1964) makes the point as follows (p. 124, Footnote 8):

> When a corporation borrows funds on notes endorsed by its shareholders, the expectation of the parties is that the corporation will be successful enough to pay off the borrowed funds itself. But this is equally true when the shareholders make "loans" directly to a thin corporation; the intent to have the corporation pay off the "loans" is, in such instances, regarded as no more than an intent to have the corporation pay dividends. So with guaranteed loans. An intention to repay them out of corporate profits does not make them "loans" by the bank to the corporation. They can — in appropriate circumstances — be regarded as loans by the bank to the shareholders, the proceeds of which are used by the shareholders to make capital contributions to the corporation; the

> intention to apply corporate profits to their repayment can be regarded as no more than an intention to pay disguised dividends when, as, and if the corporation's financial condition permits.

Other authorities agree. See Weyher and Weithorn, Capital Structure of New Corporations, Sixteenth Annual N.Y.U. Institute on Federal Taxation, pp. 227, 292 (1958); Holzman, The Current Trend in Guaranty Cases: An Impetus to Thin Incorporation?, 21 Tax L. Rev. 29, 47-48 (1955). See also, Bittker, Thin Capitalization: Some Current Questions, 34 Taxes 830, 834-835 (1956).

The analysis in the cited articles presupposes a thinly-capitalized corporation. Certainly the corporate taxpayer was thinly capitalized when, in considering only its debt with respect to the logging equipment, the debt to equity ratio was 159 to 1 ($238,150 divided by $1,500). In addition, the corporation borrowed additional sums totalling $75,000 from the First National Bank of Oregon to finance its initial operations (I-R. 14.)

Taxpayers argue that the paid-in capital of the corporation should be considered together with two contracts which were entered into with the Crown-Zellerbach Corporation. (Br. 10-16.) The District Court fully and fairly answered this contention (I-R. 17-18):

> There was no evidence as to the value of the two Crown-Zellerbach contacts or that these contracts had ever been appraised. Likewise, there was no evidence that the Murphy brothers, either before or after the corporation was organized, received any advantage from Crown-Zellerbach either in rates or terms over any of their competitors in this highly competitive field. There are too many bankruptcy reviews, Miller Act and breach of contract cases, and actions on bonds involving logging and road construction jobs which come into this Court, primarily because of inadequate capitalization, to place any reliance in counsel's argument that $1,500 plus two Crown-Zellerbach contracts furnished adequate capitalization for a new corporation undertaking two large logging and road construction jobs. Logging and road construction contracts are hazardous even for the most expert operators. The amount of rain that one encounters, or the amount of rock that one finds, both of which are often unforeseeable, will determine whether a contract is a bonanza or a disaster.

Taxpayers also argue that not much initial capitalization is needed in the logging business. (Br. 16-18.) This contention is refuted, however, by the fact that another logging corporation held by the Murphys was required to have an initial capitalization of $100,000. (II-R. 18.) On this appeal, the taxpayers contend that the capitalization of the new corporation should include an intangible going-concern value. (Br. 12-14.) What this value might be is left to speculation. In the event that the two Crown-Zellerbach contracts had proved

unprofitable, the corporate taxpayer which was capitalized at $1,500 would have been seriously insolvent without further infusions of new capital. Thus, without the successful conclusion to the operations for Crown-Zellerbach, the sole activity of the corporation (II-R. 9.), any value as a going concern would seem to be minimal.

The District Court noted that the assets "sold" to the corporate taxpayer by its organizers were essential for it to carry on its operations. (I-R. 16-17.) Taxpayers argue that this fact is unimportant. (Br. 19-22.) But many courts consider that it is a relevant factor in determining whether a transfer to a newly-formed corporation in substance represents an equity investment. See *Schnitzer v. Commissioner,* 13 T.C. 43, 61, affirmed *per curiam,* 183 F. 2d 70 (C.A. 9th), certiorari denied, 340 U.S. 911; *McSorley's, Inc. v. United States,* 323 F. 2d 900, 902 (C.A. 10th); *Charter Wire, Inc. v. United States,* 309 F. 2d 878, 880 (C.A. 7th), certiorari denied, 372 U.S. 965; *Rowan v. United States,* 219 F. 2d 51, 55 (C.A. 5th); *Brake & Electric Sales Corp. v. United States,* 287 F. 2d 426, 428, (C.A. 1st); *Dobkin v. Commissioner,* 15 T.C. 31, 33, affirmed *per curiam,* 192 F. 2d 392 (C.A. 2d); *Burr Oaks Corp.*

v. Commissioner, 43 T.C. 635, 647 (taxpayer's appeal pending in the Court of Appeals for the Seventh Circuit). See also, Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax L. Rev. 1, 35-36 (1960). Perhaps more important with respect to the instant case is the fact that the transfer of these operating assets was part of the plan whereby the corporate taxpayer was formed and enabled to commence operations.

It is the taxpayers' argument that this transfer should be treated as a "sale" independent of the incorporation transaction and thus outside the purview of Section 351. (Br. 27-34.)[7] However, as an essential step in the formation of the corporation, the transfer of the operating assets to it clearly represents a part of the transaction falling under Section 351. *Truck Terminals, Inc. v. Commissioner,* 314 F. 2d 449 (C.A. 9th);

[7]The taxpayers argue that the asset transfer should be viewed as an independent sale, but the District Court made the following pertinent observation (I-R. 18):

> Here the equipment was not appraised for at least six months after it was transferred to the corporation, and payment was not made for more than three months after its appraisal. Neither rent nor interest was paid; likewise, no instrument evidencing the indebtedness was executed. Payment was delayed until the last day of the taxable year because, as one of the Murphy brothers testified, the brothers did not want to pay the bank any more interest than they had to.

Houck v. Hinds, 215 F. 2d 673, 676 (C.A. 10th); *Gunn v. Commissioner,* 25 T.C. 424, 436, affirmed *per curiam,* 244 F. 2d 408 (C.A. 10th). See also, *Helvering v. Limestone Co.,* 315 U.S. 179, 184; *ACF-Brill Motors Co. v. Commissioner,* 189 F. 2d 704, 707 (C.A. 3d), certiorari denied, 342 U.S. 886. That the corporate taxpayer was formed for the very purpose of taking over these assets (II-R. 9), that the assets were transferred within a month thereafter (I-R. 14), that the logging contracts with Crown-Zellerbach were then entered into (I-R. 14), and that at a later date the corporation received its $1,500 paid-in capital, certainly establish that each of the steps was an integral part of the incorporation to be examined under Section 351. Indeed, if a corporation's controlling shareholders can so easily disassociate an integral step in the formation of a corporation merely by calling it a sale, then Section 351 might as well be considered an election section. Of course it is not an option provision. *Truck Terminals, Inc. v. Commissioner,* 314 F. 2d 449, 457 (C.A. 9th); *Pocatello Coca-Cola Bottling Co. v. United States,* 139 F. Supp. 912, 915 (Idaho); Bittker, Federal Income Taxation of Corporations and Shareholders (Student ed., 1964), pp. 103-104.

Taft v. Commissioner, 314 F. 2d 620 (C.A. 9th),

and *Miller's Estate v. Commissioner*, 239 F. 2d 729 (C.A. 9th), cited by taxpayers (Br. 28) are not to the contrary. In both cases the only question was whether purported debt in fact represented an equity investment, and the applicability of Section 351 was not in issue. This would seem to be equally true of *Haley v. United States* (Ore.) decided November 24, 1959 (60-1 U.S.T.C., par. 9169); *Perrault v. Commissioner*, 25 T.C. 439; *J. I. Morgan, Inc. v. Commissioner*, 30 T.C. 881, appealed and reversed on another issue, 272 F. 2d 936 (C.A. 9th); *Tauber v. Commissioner*, 24 T.C. 179; and *Brown v. Commissioner*, 27 T.C. 27, all cited by taxpayers. (Br. 28.) Moreover, in discussing the bailout aspects of such "sale" cases as *Perrault* and *Morgan*, one commentator has said (Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax L. Rev. 1, 58-59 (1960)):

> Regardless of the ultimate success of the business, the transfer of the physical plant and basic machinery must have been a contribution to the corporation's capital at the time. Until such a transfer took place, there was no corporate enterprise in the economic sense. It would seem that this was precisely the type of transaction that section 351 was designed to cover, since there was complete continuity of interest in the business.

Taxpayers point to the fact that the interests of

Peter Murphy and Harry Murphy in the assets were changed on the transfer to the corporate taxpayer. (Br. 30-31.) Since prior to the transfer this very equipment was being leased to another corporation owned by the Murphys merely for what would be the depreciation (II-R. 6), it would seem that the income produced by the equipment was in fact being shared equally by the Murphys through the earnings of the lessee corporation. Also, when consideration is given to the close relationship of the Murphys, and the fact that they were drawing equal salaries of $25,000 per year from the partnership (I-R. 2), it is submitted that the District Court properly did not attach great weight to the disproportionate interests in considering whether to treat the transferred equipment as a capital contribution. See *Reed v. Commissioner,* 242 F. 2d 334 (C.A. 2d); *Dodd v. Commissioner,* 298 F. 2d 570 (C.A. 4th); *Foresun, Inc. v. Commissioner,* 348 F. 2d 1006 (C.A. 6th); *Schine Chain Theatres, Inc. v. Commissioner,* decided April 12, 1963 (P-H Memo T.C., par. 63, 106).

Moreover, the change in proportionate interests with respect to assets transferred in a corporate organization is not supposed to affect the applicability of Section 351. Its predecessor statute (Section 112(b)(5) of the 1939 Code) required that for the section to be

applicable the stock and securities received by each transferor had to be substastially in proportion to his interest in the property prior to the exchange. This requirement caused difficulty in application, some courts contrasting the net change to each transferor in his share of the total property transferred with his share of the total stock and securities received (e.g., *Mather & Co. v. Commissioner,* 171 F. 2d 864 (C.A. 3d), certiorari denied, 337 U.S. 907) and other courts contrasting the percentage of gain or loss of each transferor in relation to property transferred by him (e.g., *United Carbon Co. v. Commissioner,* 90 F. 2d 43 (C.A. 4th)). See Hoffman, The Substantial Proportionment Requirement, 5 Tax L. Rev. 235 (1950). The 1954 Code dropped the proportionate interest requirement as a factor in the nonrecognition of gain. S. Rep. No. 1622, 83d Cong., 2d Sess., pp. 264-265 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4902) comments on this change as follows:

> In eliminating the proportionate interest test, your committee intends that no gain or loss will be recognized to a transferor transferring property to a corporation under section 351, irrespective of any disproportion of the amount of stock or securities received by him as a result of the transfer. Thus, if M and N each owning property having a value of $100 transfers such property to a newly formed corporation X, and M receives all of the stock, such transaction would not be subject to tax

> under section 351. To the extent, however, that the existing disproportion between the value of the property transferred and the amount of stock or securities received by each of the transferors results in an event taxable under other provisions of this code, your committee intends that such distribution will be taxed in accordance with its true nature. * * *
>
> In any case in which the stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts, to pay compensation, or to satisfy obligations of any kind.

See also, Treasury Regulations on Income Tax (1954 Code), Section 1.351-1 (b) (1) (Appendix A, *infra*).

Taxpayers refer to Sections 1239, 1245 and 1250 of the 1954 Code[5] and argue that because these sections do not apply here the Government is seeking a judicial solution to a problem that Congress should be asked to supply. (Br. 32-34.) We fail to understand this argument, because we agree that these three sections are obviously not applicable. However, Section 351 is a Congressional determination with respect to incorpora-

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[5]Section 1245 was added to the 1954 Code by Section 13(a) of the Revenue Act of 1962, P.L. 87-834; Section 1250 was added by Section 231 of the Revenue Act of 1964, P.L. 88-272, 78 Stat. 19.

tion transactions which clearly applies to the instant case.

Taxpayers argue that even if the transfer of assets to the corporate taxpayer is considered as part of the transaction of incorporation under Section 351, nevertheless the cash received by the Murphy brothers is "boot" under Section 351(b). (Br. 34-35.) If this contention were correct, then the gain on the exchange to the extent of this "boot" would be taxable, and a corresponding basis adjustment under Section 362(a) would be required. This argument, however, disregards the holding below. The District Court found that the logging equipment transferred to the corporate taxpayer was a capital contribution and that the loan proceeds were received by the Murphys as individuals pursuant to a loan to them from the bank. (I-R. 19.) There was no "boot" flowing to them from the corporation. As we will next consider, the District Court carefully appraised the loan transaction and reached a proper conclusion.

II

THE DISTRICT COURT DID NOT ERR IN HOLDING THAT A BANK LOAN OF $240,000 PURPORTEDLY MADE TO THE CORPORATE TAXPAYER WAS IN SUBSTANCE A LOAN TO HARRY, EDWARD AND PETER MURPHY AS INDIVIDUALS.

The corporate taxpayer was formed in February, 1959, and began operations in March when it received its operating assets and entered into two contracts with Crown-Zellerbach. (I-R. 13-14.) By the end of July, the corporation had already borrowed $75,000 from the First National Bank of Oregon. (I-R. 14.) On December 31, 1959, the corporation borrowed an additional $240,000 from the bank, and $238,150 of this went immediately to the Murphys' partnership. (I-R. 14.) The bank took no mortgage on the corporation's assets. But what is important is the fact that the loans were guaranteed by the Murphys as individuals. (I-R. 18.) As the District Court noted, these individuals had more than ample assets to justify the bank loans. (I-R. 16, 18.) On the other hand, the corporation's assets left the bank without any cushion as protection for its loan, and both before and after the loan the corporation's asset-to-liability ratio was, at best, one to one. (I-R. 18.) The District Court in the exercise of its wisdom and experience did not believe that the bank would have made such a loan without the guarantee

and that the loan was in fact made to the Murphys as individuals. Cf. *Maurer* v. *Commissioner,* 30 T.C. 1273, 1290, foot-note 2, and *Ellisberg* v. *Commissioner,* 9 T.C. 463. Of course, the District Court was entitled to consider the demeanor of the witnesses who testified at the trial and to give their testimony such weight as was warranted under the circumstances. *Wood* v. *Commissioner,* 338 F. 2d 602, 605 (C.A. 9th).

In *Commissioner* v. *Court Holding Co.,* 324 U.S. 331, an apartment house was the sole asset of the taxpayer-corporation. The apartment house was transferred as a liquidating dividend to the corporation's two shareholders and they in turn formally conveyed it to a purchaser who had originally negotiated for purchase with the corporation. The Supreme Court sustained the Tax Court in holding that the sale was by the corporation. The applicable principle was stated by the Supreme Court as follows (p. 334):

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consumation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter

> as a conduit through which to pass title. [Footnote omitted.] To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

See also *Schulz v. Commissioner,* 294 F. 2d 52, 56 (C.A. 9th).

In *United States* v. *Cumberland Pub. Serv. Co.,* 338 U.S. 451, 456, the Supreme Court made it clear that the determination of the factual category in which a particular transaction belongs is a matter within the province of the trial court. As this Court held in *United States* v. *McNair Realty Co.,* 298 F. 2d 35, 36, it is "for the trial court to draw inferences and determine what the evidence means".

The principle of these cases is fully applicable here. The District Court held as follows (I-R. 19):

> The various transactions were a masquerade to enable the brothers to step up the value of greatly depreciated equipment by approximately $210,000, withdraw it from the business, and pay taxes thereon at the reduced long-term capital gains rates, and at the same time continue to operate the business with the same equipment and with the same degree of control as they did when the equipment was in the partnership.
>
> The real substance of these transactions consisted of a capital contribution of equipment by the

> brothers to the corporation and a loan by the bank to the brothers as individuals.

The holding that the corporate taxpayer was used as a mere conduit, with its shareholders as the real borrowers, is a factual conclusion properly reached by the District Court and is not clearly erroneous.

The taxpayers do not claim that if the conclusions of the District Court are sustained, the corporate taxpayer is entitled to the deduction for interest paid to the bank. See Eskimo Pie Corp. v. Commissioner, 4 T.C. 669, 675, affirmed *per curiam,* 153 F. 2d 301 (C.A. 3d); *Orange Securities Corp.* v. *Commissioner,* 45 B.T.A. 24, 31, affirmed, 131 F. 2d 662 (C.A. 5th); *Koppers Co.* v. *Commissioner,* 8 T.C. 886, 892, on rehearing, 11 T.C. 894, 902. Also, if the conclusions of the District Court are sustained, taxpayers do not deny that while the Murphys individually are entitled to the interest deduction for amounts paid on their behalf as interest by the corporation, payment of the obligation to the bank is dividend income to them as shareholders. See *Schalk Chemical Co.* v. *Commissioner,* 304 F. 2d 48, 50, 52-53 (C.A. 9th); *Wall* v. *Commissioner,* 164 F. 2d 462, 464 (C.A. 4th); *Heman* v. *Commissioner,* 283 F. 2d 227, 231 (C.A. 8th); *Ferro* v. *Commissioner,* 242 F. 2d 838, 842-843 (C.A. 3d).

CONCLUSION

For the foregoing reasons, the judgment of the District Court should be affirmed.

Respectfully submitted,

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JANUARY, 1966.

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

Dated: 21st day of January, 1966.

MICHAEL L. MOREHOUSE

Assistant United States Attorney

APPENDIX A

Internal Revenue Code of 1954:

SEC. 163. INTEREST.

(a) *General Rule.* —There shall be allowed as a deduction all interest paid or accured within the taxable year on indebtedness.

* * *

(26 U.S.C. 1958 ed., Sec. 163.)

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) *General Rule.* —No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) *Receipt of Property.* —If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then —

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus
(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

(c) *Special Rule.* —In determining control, for purposes of this section, the fact that any corporate transferor distributes part or all of the stock which it receives in the exchange to its shareholders shall not be taken into account.

* * *

(26 U.S.C. 1958 ed., Sec. 351.)

SEC. 362. BASIS TO CORPORATIONS.

(a) *Property Acquired by Issuance of Stock or as Paid-In Surplus.* —If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

* * *

(26 U.S.C. 1958 ed., Sec. 362.)

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

* * *

(c) *Control.* —For purposes of part I (other than section 304), part II, and this part, the term “control” means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

(26 U.S.C. 1958 ed., Sec. 368.)

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) *Computation of Gain or Loss.* — The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.* —The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determinng the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) *Recognition of Gain or Loss.* —In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

* * *

(26 U.S.C. 1958 ed., Sec. 1001.)

SEC. 1002 RECOGNITION OF GAIN OR LOSS.

Except as otherwise provided in this subtitle, on

the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

(26 U.S.C 1958 ed., Sec. 1002.)

Treasury Regulations on Income Tax (1954 Code):

§ 1.351-1 *Transfer to corporation controlled by transferor.*

* * *

(b) (1) Where property is transferred to a corporation by two or more persons in exchange for stock or securitties, as described in paragraph (a) of this section it is not required that the stock and securities received by each be substantially in proportion to his interest in the property immediately prior to the transfer. However, where the stock and securities received are received in disproportion to such interest, the entire transaction will be given tax effect in accordance with its true nature, and in appropriate cases the transaction may be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts (section 2501 and following), to pay compensation (section 61(a)(1)), or to satisfy obligation of the transferor of any kind.

(2) The application of paragraph (b)(1) of this section may be illustrated as follows:

Example (1). Individuals A and B, father and son, organize a corporation with 100 shares of common stock to which A transfers property worth $8,000 in exchange for 20 shares of stock, and B transfers property worth $2,000 in exchange for 80 shares of stock. No gain or loss will be recognized under section 351. However, if it is determined that

A in fact made a gift to B, such gift will be subject to tax under section 2501 and following. Similarly, if B had rendered services to A (such services having no relation to the assets transferred or to the business of the corporation) and the disproportion in the amount of stock received constituted the payment of compensation by A to B, B will be taxable upon the fair market value of the 60 shares of stock received as compensation for services rendered, and A will realize gain or loss upon the difference between the basis to him of the 60 shares and their fair market value at the time of the exchange.

Example (2). Individuals C and D each transferred, to a newly organized corporation, property having a fair market value of $4,500 in exchange for the issuance by the corporation of 45 shares of its capital stock to each transferor. At the same time, the corporation issued to E, an individual, 10 shares of its capital stock in payment for organizational and promotional services rendered by E for the benefit of the corporation. E transferred no property to the corporation. C and D were under no obligation to pay for E's services. No gain or loss is recognized to C or D. E received compensation taxable as ordinary income to the extent of the fair market value of the 10 shares of stock received by him.
(26 C.F.R., Sec. 1.351-1.)

APPENDIX B

EXHIBIT B I

CONSTRUCTION, BALLASTING, AND/OR ROAD IMPROVEMENT CONTRACT

THIS AGREEMENT, Made and entered into as of the 1st day of March, 1959, by and between CROWN ZELLERBACH CORPORATION, a Nevada Corporation, hereinafter called the "Corporation", and MUR-

PHY TIMBER COMPANY, an Oregon corporation, 836 Pacific Building, Portland, Oregon, hereinafter called the "Contractor" (the term "Contractor" as used in the singular herin [sic] shall likewise apply to a corporation and/or two or more individuals operating under an assumed name or as co-partners).

* * *

2. LABOR, EQUIPMENT AND MATERIAL: The Contractor shall furnish all labor, equipment, material and supplies necessary to complete the work provided for herein, except as may be hereinafter specifically stated.

* * *

5. TERM: The term of this Contract shall be from the date hereof to and including December 31, 1959, and time being of the essence, the Contractor agrees to aggressively prosecute said work at all times so as to complete performance hereunder at the earliest possible date, but in any event not later than the above said date.

* * *